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Date:

June 16, 2009

Legend:

Taxpayer =

Trust =

Plan =

State =

Board =

State Board =

Regional Authority =

Authority Act =

Trust Act =

Dear :

This is in reply to your letter dated January 21, 2009, and subsequent correspondence, in which you request various rulings on behalf of Taxpayer with respect to Plan and Trust.

FACTS

Taxpayer is a State municipal corporation created pursuant to the Authority Act. Taxpayer is governed by the Board, which is appointed by a State and a local government official. An incompetent, neglectful, or malfeasant Board member may be removed by the government official who appointed him. Pursuant to State statute, the Regional Authority controls and allocates State or Federal funds for Taxpayer's finances and operating costs. The Regional Authority also uses local operating assistance to pay the ongoing costs associated with Taxpayer's operation and management.

The Trust Act required the establishment of Trust. Trustees are appointed in accordance with the procedures of the Trust Act. The Trustees adopted Trust Agreement creating Trust in order to provide eligible retirees of Taxpayer and their spouses and dependents retiree medical benefits in accordance with the Trust Act and the terms of Taxpayer's underlying health benefits program (Plan). In accordance with the Trust Act, Trust shall become solely responsible for such benefits.

No private interests participate in, or benefit from, the operation of Trust other than for the payment of reasonable costs as providers of goods and services. Trust assets include all contributions received by Trust on behalf of any of Taxpayer's employees, including the net proceeds of certain bonds and notes and employee and Plan participant contributions, together with the income and earnings from such contributions. The assets are only available to pay post-employment medical benefits of employees of Taxpayer and their spouses and dependents. The Trustees may invest Trust assets in any of the investments that are permitted investments for the investment of money held in one or more of the pension or retirement systems of State, any unit of local government, or school district, or any agency or instrumentality thereof. Alternatively, the Trustees may vote to transfer Trust asset investment responsibility to the State Board.

Trust's assets are held in trust for the exclusive purpose of providing post-employment medical benefits to the employees of Taxpayer, their spouses and dependents, and defraying the reasonable expenses associated with providing these benefits, and cannot be used for or diverted to any other purpose. No amendment of the Trust Agreement by the Trustees shall divert the corpus or income of Trust to a purpose other than providing post-employment medical benefits in accordance with the terms of the Trust Act.

Trust proposes to amend its bylaws to clarify that in no case shall there be a distribution by Trust to an entity that is not a state, a political subdivision of a state or an entity the

income of which is excluded from gross income under section 115 of the Internal Revenue Code (the Code). In the event Trust is to be dissolved and any assets remain in Trust at that time, those assets shall be used for the exclusive benefit of retirees, spouses and dependents in accordance with Trust Act and Plan.

Trust Act requires the Trustees to establish Plan to provide retiree medical benefits for the retirees of Taxpayer and their spouses and dependents. An individual who terminates employment with Taxpayer on or after the effective date of Trust Act will be an eligible retiree for purposes of Plan if, on the employment termination date, the individual (a) is at least age 55, (b) retires with at least 10 years of continuous service with Taxpayer, and (c) satisfies other rules in Trust Act and meets the requirements of any rules or regulation promulgated by the Trustees.

Trust is funded by the net proceeds of bonds and notes issued by Taxpayer pursuant to Trust Act. Funding also consists of employee and participant contributions. Specifically, the Trust Act requires employees to contribute three percent of their compensation to the Trust. Employees may not choose among cash, benefits and making the contribution. Rather, the three percent of compensation contributions are mandatory. Plan participant contributions may not exceed 45% of the total cost of their benefits under Plan.

The medical benefits offered to Plan participants consist solely of insured group accident and health plans.

LAW AND ANALYSIS

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under section 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct. In addition, pursuant to section 6012(a)(2) and the underlying regulations, the investment fund, being classified as a

corporation that is subject to taxation under subtitle A of the Code, was required to file a federal income tax return each year.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) was excludable from gross income under section 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

Trust provides medical benefits to retired employees of Taxpayer, their spouses and dependents. Taxpayer is a municipal corporation of State. Providing medical benefits to former public employees constitutes the performance of an essential government function. Based upon Rev. Rul. 90-74 and Rev. Rul. 77-261, Trust performs an essential governmental function within the meaning of section 115(1) of the Code.

The income of Trust accrues to Taxpayer. No private interests participate in or benefit from the operation of Trust other than as providers of goods or services. The Trust's dedication of its corpus or income exclusively for the benefit of the retirees, their spouses and dependents, satisfies an obligation Taxpayer has assumed or been assigned with respect to providing health benefits to its employees. The benefit to Taxpayer's participating employees, their spouses and dependents, is incidental to the public benefit. See Rev. Rul. 90-74.

Section 61(a)(1) of the Code and section 1.61-21(a)(3) of the Income Tax Regulations provide that, except as otherwise provided in subtitle A of the Code, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

However, section 106(a) of the Code provides that gross income of an employee does not include employer-provided coverage under an accident or health plan.

Section 1.106-1(a) of the regulations provides that the gross income of an employee does not include contributions which his employer makes to an accident or health plan for compensation (through insurance or otherwise) to the employee for personal injuries or sickness incurred by him, his spouse, or his dependents, as defined in section 152. The employer may contribute to an accident or health plan either by paying the premium (or a portion of the premium) on a policy of accident or health insurance covering one or more of his employees, or by contributing to a separate trust or fund (including a fund referred to in section 105(e)) which provides accident and health benefits directly or through insurance to one or more of his employees. However, if the insurance policy, trust or fund provides other benefits in addition to accident or health, section 106 applies only to the portion of the contributions allocable to accident or health benefits.

Coverage provided under an accident and health plan to former employees and their spouses and dependents is excludable from gross income under section 106. See Rev. Rul. 62-199, 1962-2 C.B. 32; Rev. Rul. 82-196, 1982-2 C.B. 53.

But, employer-provided coverage under an accident or health plan for personal injuries or sickness incurred by individuals other than the employee, his or her spouse, or his or her dependents (as defined in § 152) , is not excludable from the employee's gross income under section 106.

Section 3402(a) requires employers paying wages to deduct and withhold income tax on wages. For income tax withholding purposes, section 3402(a) provides that the term "wages," with certain exceptions, means all remuneration for services performed by an employee for an employer. However, Rev. Rul. 56-632, 1956-2 C.B. 101, holds that when premiums paid by an employer under policies providing hospital and surgical services are excludable from the employees' gross income under section 106, the amounts paid by the employer are not subject to Federal income tax withholding.

Under sections 3111 and 3301, Federal Insurance Contribution Act (FICA) tax and Federal Unemployment Tax Act (FUTA) tax, respectively, excise taxes are imposed on the employer in an amount equal to a percentage of the wages paid. Under section 3101, FICA tax is also imposed on the employee. Under sections 3121(a) and 3306(b), the term "wages" for FICA and FUTA tax purposes means, with certain exceptions, all remuneration for employment. However, sections 3121(a)(2) and 3306(b)(2) provide that the term "wages" does not include any payment (including any amount paid by an employer for insurance) made to, or on behalf of, an employee, or any of his dependents, for medical or hospitalization expenses.

Based on the information submitted and representations made, we conclude as follows:

(1) Provided the amendment to the Trust bylaws described above is adopted and, as of the date the amendment is adopted, the income of Trust will be derived from the exercise of an essential governmental function and will accrue to a state or a political subdivision thereof for purposes of section 115(1). Accordingly, Trust's income will be excludable from gross income under section 115(1) of the Code.

(2) Contributions paid to Plan (including mandatory employee contributions) which are used exclusively to pay for the accident or health coverage of retired employees, their spouses and dependents (as defined in section 152) are excludable from gross income under section 106. However, to the extent individuals are covered under Plan who do not qualify as a spouse or dependent (under section 152) of the employee, the Plan will, in accordance with applicable tax law, include in the gross income of those employees the fair market value of the coverage for the nonspouse or nondependent.

(3) Contributions paid to Plan (including mandatory employee contributions) which are used exclusively to pay for the accident or health coverage of retired employees, their spouses and dependents (as defined in section 152) are not subject to the withholding requirements and taxes under section 3402, 3111, 3101 and 3301.

No opinion is expressed on the classification of Trust as a trust or corporation for Federal tax purposes. Further, no opinion is expressed concerning the Federal tax consequences of Plan or Trust under any other provision of the Code other than those specifically stated herein.

This ruling is directed only to the Taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to your authorized representatives.

Sincerely,

Harry Beker, Branch Chief
Health and Welfare Branch
Office of Associate Chief Counsel/Division
Counsel (Tax Exempt and Government Entities)